

The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services. See, Eighteenth Supplemental Order, Cause No. U-85-23, et al (December 1986). Vertical services such as call waiting, or any other services that use the loop, should receive an allocation of the loop's costs.]Fourth Supplemental Order, Docket No. UT-941464, p. 39.]

Staff reads too much into this section of the Interconnection order. The question before the Commission in that case was whether residential local exchange service was priced below its incremental cost. In the quoted passage the Commission merely noted that the Company had made an error in its calculation by including 100% of the loop cost but less than 100% of the revenues derived from use of the loop. Based on the decision in U-85-23, one should not expect local service to be expected to cover 100% of loop costs, because some loop costs had been assigned to other services. The issue here is much broader and should not be controlled by the assignment provided for in U-85-23.⁴⁵

3. Choice of an Analytical Model and Documentation for that Model

USWC submitted incremental cost studies that were developed using various in-house cost models. The manuals alone for these models (Ex. 340) are about 1 1/2 inches thick. Other parties have criticized USWC for lack of adequate documentation and access to these models, as well USWC's use of proprietary data in the models. AT&T goes beyond merely saying that USWC should do a better job with its models and argues that the Commission should take cost studies out of USWC's hands:

The Commission should rely instead on independent studies that use publicly available information. In sharp contrast to the impenetrable maze presented by US WEST, such studies employ transparent methodologies to evaluate verifiable, nonproprietary data. (AT&T rate design brief, 11).

⁴⁵ The allocation factors proposed by Staff can be likened to the ADSRC methods proposed by USWC. Both approaches provide a mechanism for allocating shared costs such as the local loop to individual services for pricing purposes. Neither approach yields the economic price floor or accurately measures the incremental cost of a service. Even as a pricing principle, either method would produce arbitrary results that do not reflect either competitive realities or the public policy considerations that should guide the setting of individual rates.

AT&T suggests the Hatfield Model as the nonproprietary replacement for estimating the cost of basic local telephone service.⁴⁶ The Hatfield Model uses publicly-available (that is, non-confidential) cost information from USWC and other sources, and it incorporates elements of the Benchmark Cost Model that has been presented to the FCC by USWC and others in the context of universal service funding.

MCI also suggests the Hatfield Model "deserves serious attention by the Commission." TRACER recommends that the Commission consider in the future use of the Hatfield Model. Neither Staff nor Public Counsel address the merits of the Hatfield model, but both parties criticize USWC's approach as a "black box" whose operation is not understandable.

USWC opposes use of the Hatfield model to estimate the incremental cost of its local service, arguing that its methodology and inputs are invalid. The model was designed to identify geographic areas that are expensive to serve, USWC argues, not to estimate the average cost of serving all areas. USWC argues that AT&T has not provided documentation for the model and has not justified much of the data used as inputs. Another problem, USWC contends, is that the model uses embedded costs in some cases.

AT&T responds that the model is publicly available; indeed, it uses an intermediate Benchmark Cost Model whose developers include USWC. AT&T argues that the study's incremental cost calculations use as much USWC-specific data as is publicly available, and that this reliance on publicly available data represents a strength of its approach, since the results can be audited more easily. The Commission agrees. Every cost number supplied by USWC has been marked "confidential." Using USWC's estimates therefore requires that we set rates without the ability to tell the public the costs on which those rates are based. In some cases that secrecy may be necessary, but it certainly should be avoided where reasonable alternatives exist.

The Commission rejects USWC's cost studies for local service and the local loop. The most reasonable and accurate measure of incremental cost for these services on this record is provided by the Hatfield model sponsored by AT&T. While USWC complained that the Hatfield Model is inaccurate as to USWC, it provided little verification of its claim. We are satisfied from comparisons of underlying assumptions and comparisons of inputs that it accurately reflects costs incurred by USWC and that, if it errs, it likely errs on the high side through the inclusion of an overhead factor. Correcting the USWC local exchange model with the tools and input available also provides verification for the Hatfield model.

For other services, no party offered an alternative to studies prepared using USWC's models. The USWC models for services other than local exchange, without shared costs and with appropriate inputs as discussed below, are not precise but are sufficient for reference purposes to estimate incremental costs of services other than local exchange service and the local loop.

⁴⁶ See, Ex. 760-T, pp. 4-17; Exhibits 761-T, 762, 763, 764, 765-T, 766, and 767.

4. Overhead Factor

Commission Staff proposes to increase all incremental cost values by an "overhead factor" of 16.41%. The Hatfield Model sponsored by AT&T includes an overhead factor of 6%. Incremental costs usually do not include overhead or administrative costs of the firm, recognizing that those costs will be incurred regardless of whether a particular service is offered. Staff argues that overhead costs actually are sensitive to the number of services being provided. There may be merit to the Staff concerns, but the solution is to identify those costs and include them directly in incremental costs rather than impose an across-the-board multiplier on all results. Moreover, the use of such a factor would suggest more precision than actually exists in the cost study results, which are at best estimates of the actual incremental cost of providing each service. The proposal to inflate incremental costs by an overhead factor should be rejected.

B. Inputs

Some disagreement involved the propriety of various elements of data to be considered (called "inputs") in an appropriate study.

1. Depreciation Rates

The Commission has determined that for regulatory purposes, cost studies should use the depreciation rates prescribed by the Commission. USWC submitted cost studies with greater depreciation expenses, i.e., faster depreciation. Staff, Public Counsel and others argue that USWC should use the economic lives prescribed by the Commission in setting the company's depreciation rates. The parties appear to agree that incremental cost studies should reflect the economic life of the facilities. Their disagreement centers on whether the Commission's depreciation rates reflect the best estimates of economic life (as Staff claims) or a policy of understating depreciation in order to hold down current rates (as USWC claims).

USWC argues that the prescribed depreciation rates are outdated (three years old) and based on backward-looking historical data. USWC says the Commission already decided in the interconnection order that real, current expense inputs should be used in cost studies.

According to Commission Staff, however, "The (Commission-)prescribed lives are economic lives, they are just not the economic lives the Company wants." (Commission Staff Rate Design brief, p. 13). Staff's argument is correct.

The Commission determines appropriate depreciation rates for regulatory purposes on a frequent basis. As noted in a prior Order in this proceeding, the Commission has just completed a review of depreciation methodology and rates and has approved changes. The Company has sought judicial review of that decision and although now on remand to the Commission, review is not complete. Other depreciation groups will be reviewed very soon in a collaborative procedure called "represcription" involving representative s of the Company, the

Commission Staff, and the Federal Communications Commission. That process, which recurs every three years, is now beginning and according to the record it is typically completed swiftly. The depreciation rates challenged by the Company are rates that were considered in the prior proceeding or are subject to review in the represcription process. The Commission finds that the authorized depreciation rates are proper for cost study use and that they sufficiently reflect USWC's costs that they may be used in an accurate cost study and for ratemaking purposes. We see no reason to approach matters on a piecemeal basis, litigating matters incessantly, when it is both functional and appropriate to make a single and consistent timely determination of appropriate depreciation rates for all regulatory purposes. The function of depreciation, estimating the actual economic lives of physical properties, is identical in every instance. It is far better to have a single consistent and timely approach to depreciation than to relitigate it unnecessarily.

2. Cost of Money

In the interconnection case, Docket No. UT-941464, the Commission determined a forward-looking cost of money may be appropriate for use in a cost study. Parties do not appear to disagree with this principle, though their opinions vary on the right estimate of cost. In addition, Public Counsel argues that using the last-authorized rate of return could provide stability and prevent relitigation of cost of money in rate design cases. The Commission agrees that any theoretical advantage to using "pure" forward-looking values would be more than offset by the practical problems of turning every cost-based rate filing into a cost of money case. The last authorized rate of return provides a reasonable measure of the cost of money for this purpose and will be accepted as an appropriate principle.

3. Fill Factors

"Fill factors" describe the amount of unused capacity that will be included in the cost of a particular service. USWC argues that actual fill levels are often below the objective or planning level and that using objective fill factors would cause the cost of spare capacity necessary to provide a particular service to be treated as a shared cost of all services. USWC says the use of objective fill understates the true cost of particular services and that actual fill factors should be used instead. Staff and Public Counsel have presented evidence that actual fill factors would produce excessively high estimates of incremental cost.

The Commission has previously ordered USWC to develop cost estimates using objective fill factors, and we will continue to require the use of objective fill. In situations where capacity is being underutilized, incremental cost calculations would include costs of capacity that is not required to provide that level of service. That would be inconsistent with the theory that incremental cost studies should be prepared on a forward-looking basis and without respect to the actual costs incurred in the past. Using objective fill will assign a reasonable portion of unused capacity to individual services. The remaining unused capacity is most appropriately treated as a shared cost. This issue ultimately has no effect on whether USWC recovers the cost of this unused capacity, since shared costs also are recovered in rates.

4. Wire Pairs in Residential Loop Cost

USWC's cost study for residential exchange service and the residential loop includes the cost of three wire pairs. USWC includes only a single pair in the cost of a business loop. Only one pair (plus a fraction to allow for bad wires, which is accounted for in the objective fill value) is required to provide service. Staff and Public Counsel argue the three-pair assumption overstates the cost of a residential line. Additional pairs are installed only because USWC expects residential customers to order additional lines. The Commission so finds. The cost of the additional pairs should be matched with the additional-line service for which they are installed and should not be included in the cost of the first line.⁴⁷

5. Weighting of Design Types

The USWC cost studies do not estimate the cost of every possible combination of loop lengths, switches, etc. Instead, costs are developed for several designs, and these are weighted to arrive at an overall number for incremental cost of average service. Public Counsel argues that the weights are based on judgment and not properly documented. Public Counsel contends that USWC was unable to show how the actual distribution of access lines matches with its design types. USWC's cost witness, Mr. Farrow, responding to questions from the bench, said that the weighing is based on an analysis of Washington state data.

The Commission accepts USWC's explanation for this proceeding. However, it is an example of the more general and continuing problem relating to documentation and auditing of USWC's cost studies. Other parties *must* be able to verify USWC's results if the company's cost studies are to be relied upon in setting regulated rates. Parties have provided specific recommendations as to how USWC can improve its documentation. Until those improvements are made, the Commission will limit its reliance on USWC's results and will encourage parties to sponsor alternative results such as those of the Hatfield model.

C. Results

The most important question to be answered by cost studies in this case is whether residential local exchange service is being cross-subsidized by business and toll service. USWC argues that this cross-subsidy exists and is undermining its ability to remain competitive. Other parties, including Staff, Public Counsel, TRACER, MCI, and AT&T, argue that the residential local service rate covers its incremental cost.

⁴⁷ The three-pair error has no direct bearing on the decisions of this case, because the Commission has already rejected USWC's entire residential exchange service and local loop cost study in favor of the Hatfield model results. This error was one factor in the Commission's decision to rely on the Hatfield model results. US WEST's argument that it will be grievously deprived of its rights and its opportunity to recover its costs if the additional pairs are deemed shared or common rather than incremental costs in its cost study is silly, as the Company is allowed under regulation to recover both its shared or common costs and its incremental costs.

The evidence clearly shows that residential service is covering its cost. The incremental cost of local exchange service is approximately \$4.42. This amount is calculated by subtracting the Hatfield model results for loop cost (\$8.96 [Ex. 765-T, 4]) from the Hatfield model results for the total cost of local service (\$13.38 [Ex. 767]), using the modified fill factors. These values are only approximate, in part because any model result is only approximate and in part because the Hatfield model results do not necessarily reflect the input values determined earlier to be appropriate.

The conclusion to be drawn from these cost results is that residential service does not receive a subsidy at current rates. The average residential customer today pays \$10.50 for local service and EAS adders, plus a subscriber line charge of \$3.50. If USWC were to exit the local residential exchange market, its revenues would decrease by \$14.00 per customer, and its costs would decrease by about \$4.42 per customer. Not only does residential service cover its incremental cost (the test for cross-subsidy), it even covers the incremental cost of the local loop that is used to provide local, long-distance, and vertical services, since the revenue from local service, including the subscriber line charge, exceeds the \$13.38 cost of local service plus the local loop.

III. Cost/Revenue Requirement Relationships

The parties generally agreed that rates should be based on, but not necessarily equal to, long-run incremental cost. There also was a consensus among those addressing the issue that the Company's revenue requirement will require that rates be set above TSLRIC. No party proposed a specific method of establishing a relationship between prices and incremental costs that could apply across all services.

The price/cost relationship under existing rates for most USWC services is summarized by the Company in confidential Exhibit 485-C. USWC contends that Ex. 485-C shows the relationship between incremental cost and revenue for most USWC services. Currently, the Company argues, toll and business basic exchange service contribute more than 100% of USWC common costs. These services are at competitive risk, says USWC, and toll revenue is declining. The Company cites asserted problems with rates for residential services, Directory Assistance, and Terminal Loop services. It contends that, even with its proposed rebalancing, switched access and basic business local exchange service would subsidize other services.

Commission Staff argues that Ex. 485-C does not show what level of overall markups would apply on average to reconcile incremental costs with revenue requirement. They note that the exhibit contains outdated data on switched access revenue, is only a preliminary analysis, does not use consistent methodologies and inputs, assigns all residential loop costs to local service, and accounts for services providing less than 95 percent of revenues. In addition,

Commission Staff argues that it did not have adequate opportunity to assess the support for the information. It argues that even according to the exhibits, both toll and local rates are above TSLRIC.

Public Counsel/AARP acknowledge that even with its flaws, Ex. 485-C shows that USWC must price above Total Service Incremental Cost (TSIC) to earn a fair return. Properly interpreted, however, Public Counsel contends that the exhibit shows that residential rates exceed TSIC.

The Commission finds that many problems with this exhibit limit its usefulness. It was filed very late in the case; it was revised repeatedly; it does not include all services; and costs are not calculated on a consistent basis. Loop and local exchange costs are based on the USWC study that we reject in this order. With those limitations in mind, however, we find that it does provide a general sense of the relative levels of contribution of various services. Within the context of this proceeding the data in it can provide a useful guide for rate spread decisions, as long as limitations of the data are kept in mind.

The Commission will not attempt to set an equal markup of prices over the incremental costs of various services. That is neither required by competitive pressures nor generally practiced in unregulated markets. It could well produce illogical and uneconomic results, such as some services being priced above market level, causing USWC to exit a market it could efficiently serve if competitive alternatives are or become available.

Examining the relationships between a particular service's incremental cost and its present or proposed price is, however, a reasonable and appropriate factor in determining rates for individual services.

IV. Other Factors Affecting Rate Design/Rate Structure

A. Universal Service

Universal service is one of the State's basic policies with regard to telecommunications service. RCW 80.36.300. All the parties agreed that the Commission should consider universal service when considering rate design -- but each had a slightly different perspective as to what universal service may mean and how to achieve it.

USWC forthrightly acknowledges that universal service is very important and should be accommodated by assigning revenue requirement, if that is a reasonable option and still let the Company earn its revenue requirement. It contends that its proposed \$26 per month residential rate is affordable. It urges that the phased proposed increase would give time to study universal service issues. Finally, it urges that only a very small proportion of USWC customers have expressed opposition to the proposed increase.

Commission Staff disagrees with the Company's conclusion, stating that the Company's proposed increases are huge and that it is unreasonable to deny that there will be an effect on universal service. Public Counsel/AARP argue that USWC has agreed that universal service is the fundamental concept -- the number one public policy goal -- in telecommunications. They argue that at the proposed rates, 39,000 persons would leave the system and that USWC's "affordability" analysis is seriously flawed. AT&T argues that universal service is important, but shouldn't be the determining factor in setting rates. Subsidies should be targeted toward specific individuals who need them, and collected in a competitively neutral manner from all competitors. It notes that household penetration varies with toll rates, not local service rates. It urges that outmoded internal cross-subsidies needn't be perpetuated in the name of universal service, but cites cost study data that show the residential class to meet costs and provide a contribution.

DOD/FEA support universal service, but contend that the universal service objective doesn't require a subsidy to the entire residential class. It cites a Rutgers University study that found most marginal users were driven off the network by toll. DOD asks the Commission to take official notice of the federal Telecommunications Act of 1996.⁴⁸ It suggests the use of a Joint Board to develop equitable and nondiscriminatory measures.

DIS reaffirms the State's statutory Universal Service policy. WITA suggests that the Commission not use the USWC rate case to define universal service, noting that there are other forums in which this is being addressed. WITA supports the USWC offer in Ms. Owen's rebuttal, to provide for a lower rate if necessary, to those customers receiving assistance under WTAP (supported by a higher rate on others).

The Commission reiterates its concern and support for the concept of universal service. The Commission finds it unnecessary and inappropriate, however, to pursue universal service considerations in this proceeding. First, there will be no massive increase to threaten universal service. Second, the Commission has begun Docket No. UT-950724, an inquiry into universal service, to explore universal service in today's transitional regulatory environment and mechanisms by which it may be maintained. The Telecom Act at Sec. 254(a)(1) also requires that the FCC initiate rulemaking to define services that should be supported, the support mechanisms, and other changes.

The compression of residential rate groups into a single statewide rate will cause rate increases to some persons, especially persons in small, rural exchanges. Because the rates are so low, even modest increases will be a significant percentage rise and may be significant to low income individuals. Because of the low base, the modest dollar size of the increase, and the level of the resulting rates, however, the Commission is confident that its order will not adversely affect universal service within the State.

⁴⁸ The Commission believes that the Act may be cited without taking official notice. Nearly all parties have cited the Act on brief.

B. Competition

USWC argues that it faces competition in the markets that currently provide contribution to support services priced below cost: toll, access, and business local exchange. USWC cites the ease of registration as a telephone company, access to public rights of way and USWC structures, free numbering, free interconnection, low-cost number portability, low-cost private lines, a filed unbundled loop tariff, and the passage of federal legislation mandating conditions to promote local service competition. USWC contends that competition has grown to the point that the Company is beginning to have trouble handling the traffic delivered by competitors to its network.⁴⁹

Commission Staff points out that USWC enjoys a ubiquitous network funded by captive ratepayers. Staff contends that *de facto* barriers continue to exist for market entry. Staff acknowledges that competition is increasing, but contends that competitors now have a negligible market share. Staff urges that the Company can ask for competitive classification if it thinks services are competitive. Instead, says Staff, the Company argues that the existence of any competition requires it to act as though the market is fully competitive. Each of the current alternative technologies (wireless, cable, competitive land line) has its own technical and other limitations. There may be pervasive competition in the future, say Commission Staff -- but not now.

Public Counsel/AARP argue that even though there is open entry and some entrants, there is no evidence that effective competition exists in any, let alone most or all, of the markets that USWC serves. Public Counsel/AARP urge that evidence of revenue increases tends to refute USWC's claim that it is losing business to competitors. Some of the competitors USWC cites, say Public Counsel/AARP, have substantial technological or practical barriers to becoming full alternatives for the ubiquitous network. The analysis of competition should focus on price-constraining competition, not anecdotes or speculation. USWC provided no evidence demonstrating the existence of that sort of competition. We find that USWC continues to enjoy substantial advantages: a ubiquitous network on which it enjoys a unique monopoly position; access to every customer; high market shares; substantial market power; some entry barriers remain, such as lack of number portability; USWC can use "special contracts" for large users to compete with entrants; USWC has the 1 + dialing advantage; cellular is benefiting the Company by providing additional access revenues; cable has technical problems; there is no demonstration that competitive access providers (CAPs) are

⁴⁹ Nowhere in USWC's case does it address its competitors' (potential or actual) cost of providing service. USWC has not shown or attempted to show that any competitor can offer a particular service at rates below those currently charged by USWC. Instead, USWC's case for competitive threats to its profitability rests on (1) the absence of legal or regulatory barriers to competition and (2) anecdotes about plans of other firms to enter USWC's markets.

offering lower rates or having a substantial effect upon market share. We find that personal communications service (PCS), specialized mobile radio (SMR) and satellite service are in early development stages and not a competitive threat; and interexchange carriers (IXCs) use incumbents' facilities because it is to their economic advantage to do so.

AT&T argues that from the record, competition in local exchange service doesn't yet exist and that USWC cries wolf. But, AT&T argues, emerging competition will be affected by the rates that are set in this proceeding. The DOD/FEA also acknowledge that the specter of competition is much closer now that the federal Telecom Act has been enacted, adding new urgency to USWC's requested rate restructuring. WITA contends that the transition from monopoly to competitive markets demonstrates USWC's need to restructure rates. WITA argues that competition is here and that value of service pricing must be abandoned in favor of cost-based pricing.

The Commission finds that effective or price-constraining competition does not exist. The Commission concludes that, to the extent USWC has predicated its rate spread proposals on competitive threats, those proposals should be rejected. USWC witnesses were not credible in assertions as to the existence or threat of competition, and were not supported with objective information that would permit a finding that effective competition exists. Rates will not be lowered, and costs will not be shifted to captive customers, based on anecdotal evidence. To do so would not result in rates that satisfy the statutory requirements to be just, fair, reasonable and sufficient.

The Commission also recognizes, however, that competition may develop in the markets served by USWC and that it is in the best interest of both the Company and its customers to prepare for greater competition. USWC, unfortunately, has not offered a reasonable approach to emerging competition. We encourage the Company to examine the markets for its various services and, where it appears that effective competition exists, seek to have those services declared competitive as provided for in RCW 80.36.330. Such a competitive classification would enable USWC to raise or lower rates for that service in response to market conditions. Where effective competition exists, market pressures can replace traditional rate regulation.

In addition to encouraging USWC to seek competitive classification where appropriate, we believe it also is in the public interest for USWC to have downward pricing flexibility for services that, while not yet subject to effective competition, are facing competition of some sort. This can be accomplished under Washington state law by using the banded rate provision in RCW 80.36.340.⁵⁰

⁵⁰ The statute reads as follows:

80.36.340 Banded rates. The commission may approve a tariff which includes banded rates for any telecommunications service if such tariff is in the public interest. "Banded rate" means a rate which has a minimum and a maximum rate. The minimum rate in the rate band shall cover the cost of the service. Rates may be changed within the rate band upon such notice as the

USWC has sought to tie its competitive responses to its monopoly services. Its market response -- to lower rates for toll, access, and business services -- was linked to higher rates for monopoly services -- in particular, residential exchange service. In effect, USWC wanted to make residential ratepayers responsible for its success or failure to compete in other markets.

The more appropriate approach is to give USWC the tools it needs to respond to competition while still protecting captive customers from monopoly pricing. The banded rate statute is that tool. It will permit USWC to lower rates when doing so is necessary to respond to competition. If USWC determines that a particular rate established in this order is higher than the market will bear, it will have the flexibility to lower that rate and meet the market. The Commission finds that in current regulatory circumstances, the limited use of banded rates authorized in this Order is in the public interest.

This Order will therefore authorize USWC to file tariffs with banded rates for any service that it believes is likely to face competition. The upper limit for each rate should be the rate determined in this case. The lower limit should be no lower than the TSLRIC of that service, calculated in accordance with the decisions on cost studies in this order, or the price floor set through imputation where required. USWC will be allowed to change rates within the band on 10 days' notice to customers and the Commission, by analogy to the provisions of RCW 80.36.330. Within that period, the Commission may complain against the filing. If it does, the burden is on the Company to demonstrate both that the rate is above cost and that it is fair, just and reasonable. Especially important here, where we have found that the Company does not face effective, price-constraining competition in the markets for many services, proving that a price is fair, just, and reasonable involves a demonstration that it is not anticompetitive.

WAC 480-80-045 requires banded rate filings by telecommunications companies to include a statement of public interest, cost study results verifying that the minimum rate covers cost, and information on the revenue impact of the banded tariff. Because the Commission is authorizing banded rates on record evidence, including market conditions and cost studies, the Commission does not contemplate the generation of new data or studies, but authorizes USWC to refer to record evidence accepted by the Commission as valid, when the Company provides support for its proposed tariff revisions. We expect that the evidence of record will satisfy the requirements of the rule.⁵¹

commission may order.[1985 c 450 § 6.]

⁵¹ The Commission considered banded rates for USWC in Cause No. U-86-40. There, it rejected USWC's request to set a band of \$20 to \$8 for remote call forwarding, which was then tariffed at \$16. The Commission reiterates its conclusion in that proceeding that the upper band should be the revenue requirements level. The circumstances today are sufficiently different from those of years ago that the other guidelines set out in the order in U-86-40 should not apply here. However, the Commission is sensitive to the possibility of unintended consequences and reserves

There may be concern that a set of banded rates, with the upper bounds set at the revenue requirements level, could only result in rates that are insufficient, since any downward price movement would cause revenues to fall below the revenue requirement determined in this case. The Commission believes that concern to be ill-founded. USWC can be expected to use the pricing flexibility of banded rates to maximize its revenues; it is unlikely to lower rates for a service unless competition forces it to do so. Where competition exists, a rate that meets the market will generate more revenue than an above-market rate.

By granting USWC downward pricing flexibility, we are not taking away the Company's ability to seek increases in its overall revenue level or to seek a revenue neutral rebalancing of rates. If USWC believes that a reduction in rates for one service needs to be offset by an increase in rates for another service, it can request that rebalancing. Banded rate authority simply gives USWC a tool to respond more quickly to competition without putting captive customers at risk. This gives USWC more ability to compete without sacrificing our legal obligation to protect captive customers from monopoly pricing. Alternative banded rates provide USWC with the greatest level of pricing flexibility allowed under Washington law without a showing that a service is subject to effective competition.

C. Imputation and Price Floors

Imputation tests must be performed to ensure that USWC does not put a "price squeeze" on competitors using its bottleneck monopoly services. For example, the access charges paid by interexchange carriers are imputed to USWC's retail toll charges, even though USWC does not pay those access charges, to ensure that its toll rates are not anti-competitive.

According to USWC, the test is simple:

Does the price cover at least the incremental cost at the ASIC level plus imputed tariff rates for truly essential services required by competitors to provide the same or similar service? [USWC rate design brief, p. 42.]

USWC argues, however, that the only essential service is interconnection itself; everything else that could be purchased from USWC could also be self-provisioned. Thus, USWC concludes, imputation is a non-issue in this case and all USWC services pass any reasonable imputation test.

Beyond its assertion that imputation is a non-issue, USWC does not offer a point-by-point defense of the imputation calculations it placed in the record. In testimony USWC proposed several changes to existing implementation methods used by the Commission. These

the right to reopen this proceeding for the purpose of examining the effect, the performance, and the continuing propriety of banded rates filed in accordance with this Order.

include (1) excluding the local transport rate, (2) excluding access charges imposed by independent local exchange companies (ILECs), (3) and making the calculation on the average toll rate instead of individual toll rate elements.

WITA agrees with USWC that ILEC access charges should not be imputed in USWC toll rates, arguing that the exclusion best balances the policy goals of a designated carrier with those favoring the beginnings of competition.

Commission Staff agrees with the Company that all toll offerings exceed the price floor, and argues that the Company-proposed changes to imputation test are flawed and unneeded. According to Staff, only billing and collection, that have been classified as competitive, may be imputed at its long range incremental cost (LRIC); all other elements must be imputed at tariff rates. Allowing imputation at average rates would stifle competition because the Company could freely devise high-volume plans that others couldn't match. Staff contends that its view is consistent with the Commission's second and third Supplemental Orders in U-88-2052-P and the fifth Supplemental Order in U-87-1083-T.

MCI and Sprint argue that USWC's requested changes in imputation are inappropriate. AT&T criticizes USWC's proposed changes to the imputation method, without disputing that USWC's proposed rates pass the imputation test. AT&T instead argues that imputation tests are not adequate to protect competitive markets from monopoly power. If USWC's toll is priced at the imputation floor, AT&T would earn zero profits while USWC was enjoying the very high markups on access charges, and the solution therefore is to price monopoly inputs to competitors at TSLRIC.

DOD/FEA note that imputation is still required, although its importance declines as services become competitive. They argue that the price floor of incremental cost is now a mandated requirement under the federal Telecommunications Act of 1996.

The Commission rejects the Company's proposal to include only the interconnection rate in imputation. The Commission finds that unless a bottleneck service is effectively competitive, if it is necessary to the competitor using it we cannot assume that a competitor will be able to circumvent it. It must then be imputed at the tariff rate. Unless the Commission finds a service to be competitive, the Company must include all bottleneck functions in its imputation at the tariff rate. Similarly, the Commission rejects other changes that the Company urges for imputation tests. Until services are truly competitive, the Company's services are essential in practice for some or all existing and prospective competitors. Abandoning the imputation standards now in place would allow the Company to price in a manner -- even though above its TSLRIC -- that would restrain the growth and development of competition.

D. Service Differences

USWC argues that the traditional differences between services such as toll, local exchange, EAS, and private lines are disappearing. In the future, competing carriers will offer all sorts of bundled and unbundled service option packages. The Commission should not be bound by traditional concepts of utility rate discrimination when deciding upon appropriate rate spread.

Public Counsel/AARP say that the differences between business and residential service are significant and that they justify the current difference in rates. Business service includes a yellow pages listing, involves more on-peak calling and more total calling, and gets faster repair service. The cost of business service is usually tax-deductible, while residential service usually is not. Public Counsel/AARP recommend equal percentage rate reductions for business and residential service, which results in a greater dollar reduction for business.

The Commission agrees that the distinctions among services may become blurred. As more persons engage in home occupations, as providers of alternative technologies and providers of other services enter the telecommunications marketplace, and as bundling of services occurs for marketing purposes, the traditional distinctions may well blur. The Commission finds that, as with price-constraining competition, that time has not yet come and it finds that distinctions among services still exist and define those services, and that tests relating to competition and pricing should be applied on the basis of services. This Order moves rates in the direction USWC urges, and future proceedings will allow the Commission to evaluate future costs, future market conditions, and other appropriate elements in rate setting.

In this Order, the Commission will maintain the residential local exchange rate at its existing statewide average rate. It will substantially reduce the revenue requirement for comparable business services, narrowing the proportional difference. It believes, however, that the factors Public Counsel/AARP mention -- yellow pages listing, calling patterns and volumes, faster repair service, and tax-deductibility, along with considerations of universal service and gradualism -- do support maintaining a substantially higher rate for business than for residential service. The Commission is sensitive to the needs of small business and believes that reductions in business class revenues, the collapse of rate groups, and the advent of competition will work to increase service options and maintain or lower total telecommunications costs. The Commission believes that equities and social policies continue to support the distinctions among services and the rate differentials we approve in this order.

V. Local Exchange Services**A. Residential****1. Flat**

USWC proposes to increase residential rates in four annual phases, eliminate rate groups, blend EAS increments into the basic line rate, and introduce an "urban-rural" zone pricing structure. The statewide rate for a flat single party line in the final year would be \$21.85 in Zone 1 and about 20% higher at \$26.35 in Zone 2. USWC contends that residential rates must ultimately recover their fair share of costs or be supported by universal service funds. In its brief, USWC says that it must modestly deaverage its rates between urban and rural locations on a cost basis if it is to sustain its operations. It argues that residential rates are now below the national average in Washington State, that 30% of residential customers don't contribute to costs by making toll calls, and that nearly half of all customers don't contribute to costs by subscribing to ancillary services. The Company says the Commission should start by 1) setting a consolidated rate of \$19.69, including an average \$5.46 increase plus the revenues formerly provided by EAS, and 2) indicating its approval of the concept of zone pricing for future rate changes.

Commission Staff contends that the Company's costing methodology has been inconsistent with economic theory and prior orders. Staff contends that the Company has overstated the costs attributable to its basic residential service and that the existing rates are well above the monthly cost for that service (Ex. 602-T, 15-16; Ex. 605-C). If any cross subsidy exists, says Staff, it is contained within residential customers as a group -- not between residential and business customers. Staff supports the Company proposal that the current rate group/EAS additive structure be eliminated and replaced with a uniform statewide residential service rate. Staff, however, recommends a flat statewide rate of \$10 per month per line, which exceeds the monthly cost identified in Exhibit 605-C.

Public Counsel/AARP also contend that rates now cover costs and that the Company's presentation does not support an increase. They urge that common line costs are shared costs and should be recovered from all telephone users. They urge a statewide rate of \$8.43. TRACER cites Dr. Zepp (Ex. 788T and 789-C) and Mr. Spinks (Ex. 602-T and 604-C) to support its contention that residential rates are not subsidized. TRACER and DIS also support a single statewide rate, but take no position on what the rate level should be.

DOD/FEA contend that USWC cost studies for residential service were excessive but it does not endorse a rate reduction because much of the support mechanism for residential exchange service is subject to revocation under the terms of the federal Telecom Act or, for instance, in the case of Yellow Pages, is subject to erosion from increased competition. DOD/FEA contend that the Commission must be prepared for the unpleasant reality that monthly residential exchange rates probably must rise.

MCI believes the record does not require or support any significant increase in rates for residential subscriber, citing the Hatfield Model cost study as evidence that local loop and local exchange costs are covered. AT&T contends (Citing Ex. 485C and Mr. Mercer's rebuttal and supplemental exhibits, Ex. 761T through 767) that the record demonstrates that revenues attributable to local exchange service, including subscriber line and CCLC, cover their TSLRIC. AT&T urges that USWC therefore faces no revenue shortfall, and any adjustments to its local exchange service rates should be uniform.

All parties either support rolling EAS additives into the rate or make no comment.

It is clear from the record on cost study results that residential local exchange service already covers its incremental cost. There is no subsidy of this service by other services. The need to ensure that each service at least covers its own TSLRIC therefore provides no basis to increase residential rates. However, as noted above in our discussion of cost studies, it is not enough to determine that a rate exceeds TSLRIC. Residential customers share with other customers the responsibility for recovery of shared and common costs.

The appropriate level of contribution is a matter of judgment about how to weigh the public interest, equity among customer classes and groups, the public policy encouraging universal access at affordable rates, and the need to avoid sudden shifts in rates whenever possible. In this proceeding, an important factor is that no overall increase in rates is being ordered.

Having considered all of these factors, we find that the current average statewide single flat residential rate is the appropriate level for residential service in this proceeding. Residential service covers its own costs and provides a reasonable contribution to the overhead of the Company. That contribution is not so large as to justify a rate decrease. We also agree that it is appropriate to eliminate EAS additives and fold them into the average rate. The EAS charges have been established principally on the basis of lost toll revenue rather than cost. It is important to consider costs when setting rates and to use valid reasons for departing from cost.

We decline to reduce the residential class average rate. The restructuring we accomplish in this Order will allocate reductions to other classes and services based on our view of the long term public interest. We expect that it will reduce some of the pressures for future rate reductions for other classes or services, and thus benefit the residential class with more stable rates. Reductions in toll and access service will also benefit customers of those services in the residential class.

While there will be no change in the average rate for flat-rated residential local exchange service, the move to a statewide rate by eliminating the current rate group structure will result in rate increases for some customers. To mitigate against the effect of this increase, the Commission believes that the rate increase should be phased in over two years. Rates for customers whose current rate is more than a dollar below the statewide average rate should

initially move halfway to the new rate, and the remaining increase should be implemented in one year. Rates for all customers above the statewide average rate should immediately move to the new rate.

2. Measured Service

USWC proposes to eliminate the existing variable cost-per-minute structure and replacing it with a 3¢ charge for each minute. Usage packages of three and six hours would be increased by 30¢ and 85¢, respectively, per month. The Company proposes converting the remaining customers who use a frozen service called basic measured service. The measured service rate would go to \$9.25 initially and to \$13.75 over four years. According to USWC, this would simplify the cost structure and bring the rates up to cover costs.

The Commission Staff agrees that the Company's cost studies show current usage rates to be high in relation to their costs. While the Company's proposal to charge a uniform 3¢ a minute simplifies the current structure, it also increases the already high usage charges by over 50% for a four-minute call. Staff recommends that the service be restructured to better reflect the service costs for the loop and usage. Staff recommends that the rate be reduced to 1.5¢ per minute for the first minute, and 1¢ for additional minutes. Staff recommends that the measured monthly recurring line rate be increased from the current \$4.83 to \$7.00. The net revenue impact of these two recommendations is \$47,669. Finally, Commission Staff recommends that the existing measured service packages be grandfathered to avoid forcing 20,000 existing customers to migrate to higher priced alternatives. (Ex. 602-T, pp. 18-19; TR 3407-08.)

Public Counsel/AARP agree that measured service usage rates should reflect cost, proposing that the charge for the initial minute be 2.5¢, with subsequent minutes at 1¢, and with a 40 percent discount for off-peak usage. The monthly recurring rate would equal 70% of the single-line, flat, monthly residential service rate.

The Commission accepts the Public Counsel/AARP proposal. It most closely reflects the costs of the service and establishes an appropriate relationship between flat-rated and measured service. Existing budget service customers shall not be grandfathered, as Commission Staff proposes. The Commission shares Public Counsel/AARP concerns that the measured service rates cover incremental costs, and yet provide a viable option to persons who do not require flat rated service. Rate increases that result should be phased in as provided for above for flat-rated service, i.e., customers whose current rate is more than a dollar below the new rate should pay half the increase now and the remainder after one year.

B. Business

At present, the Company's rates distinguish between "simple" and "complex" business services, and vary by rate group, according to the size of the exchange. USWC proposes to restructure these relationships, eliminating the distinction between simple and complex lines;

eliminating rate groups for a statewide rate, and in the second year of rates instituting a "Zone" structure in which a higher rate would apply to service in exchanges that the Company considers "rural." In addition to this restructure, it proposes several additional changes in charges for business services.

1. Simple/Complex Service

In present rates, simple service consists of four or fewer lines; complex services consists of five or more lines. Each line in Complex service is priced higher than each line in simple service. Exchanges are divided into four rate groups, with charges higher for service in exchanges having more customers.

USWC proposes to eliminate the distinction between simple and complex services. It would also eliminate rate groups, with flat-rate single party business lines priced at \$29 statewide in the first year, up for most customers from the current statewide average of \$25.85. USWC would discount additional lines by five percent. It argues that the proposed changes in rate structure are required to bring prices more in line with costs.

Commission Staff proposes that the Commission implement the restructure approved in Docket No. UT-930957. This would result in a single statewide rate for simple and complex lines, hotel, PAL,⁵² and semipublic of \$25.85. The Centrex NAR⁵³ and the DSS⁵⁴ rates would be \$18.65.

Public Counsel do not oppose eliminating the simple/complex business line differential. TRACER supports a single statewide rate, with NAR and DSS trunk prices aligned with that rate. TRACER contends that USWC failed to justify a higher first-line charge.

DIS supports a statewide business line rate and agrees that current rates exceed costs. DIS agrees that the simple/complex distinction is a disincentive to expansion and proposes 1) pricing all business lines at one statewide rate, with the level dependent on the revenue requirement that the Commission finds; 2) aligning the NAR and DSS trunks with the statewide rate; and 3) rejecting zone pricing.

The Commission accepts the Company's proposal to eliminate the pricing distinction between simple and complex service. It is clear from the evidence that the costs of additional lines do not increase, so the simple/complex distinction is not cost-based. It is a

⁵² PAL stands for Public Access Line, a service provided to payphones.

⁵³ NAR stands for the Network Access Register, which provides access to the network and allows customers to aggregate multiple stations onto a single access port.

⁵⁴ DSS stands for Digital Switched Services and provides PBX access to T-1 facilities.

disincentive to acquire additional lines and thus can impede business communication. This is most burdensome on small business, for which the additional lines may constitute a particularly significant proportion of expenses. Hotel and toll trunks and semipublic lines should be priced at the same rate as business lines.

The Commission rejects the discount for additional business lines. The revenue requirement that we find allows a rate that is lower than any party proposed for business service and minimizes the effect upon business. A demonstration in a future case of cost differentials for additional lines may persuade us that a discount is appropriate.

The Commission will set the business exchange rate at \$25 per month. This rate provides both a reasonable contribution to the shared and common costs of the firm and a substantial rate reduction to business exchange customers. While most customers will experience a rate decrease as a result, the elimination of rate groups and the simple/complex distinction will cause rates for some customers to increase. To mitigate the short-term impact on these customers, the Commission will order a phase-in of the increase for all customers whose increase would be more than one dollar per month. Those customers should pay half the increase now and the remainder after one year.

2. Private Branch Exchange (PBX), Network Access Register (NAR), and Digital Switched Service (DSS)

USWC urges that establishing new rates for PBX, NAR and DSS is contingent upon an imputation test that includes rates established for local interconnection. Until then, the Company proposes to leave PBX trunk rates at the level of the current complex line rate. Although an interconnection filing is expected in July, 1996, no one knows when that case will be finally resolved. The Commission therefore sees no reason to delay adjusting PBX, NAR, and DSS rates consistent with other rate adjustments in this case. USWC can propose new rates for PBX trunks if it is appropriate, following resolution of the interconnection case and the filing of the appropriate imputation tests.

USWC contends that PBX trunks have unique cost characteristics. It argues that usage, and therefore usage costs, are generally higher for PBX lines than other business lines. The Company's evidence, however, shows that PBX trunk loop costs are generally lower than other business lines because the loops are typically shorter (Ex. 505.)

Commission Staff argues that Company cost studies show a minimal difference in non-traffic sensitive costs between PBX trunks and simple business lines, and that usage cost differences do not appear to justify a separate PBX trunk service. Staff does not oppose a separate usage increment for PBX. Public Counsel proposed a separate \$11 usage increment for PBX trunks to recognize the usage difference.

TRACER cites Mr. Farrow's exhibit (Ex. 341-C) to show that the \$1.06 difference in usage costs (ASIC) is partly offset by differences in loop costs, lowering the net ASIC costs between a business line and a PBX trunk to \$.65. TRACER argues that the only instance where a significant cost difference arises is between a business line and a PBX trunk that has DID, direct inward dialing. In those cases, the PBX customer pays an additional charge for the cost of DID terminations which more than makes up for the cost difference. DIS and TRACER oppose Staff's suggestion that a separate usage increment for PBX trunk customers would be permissible to recognize usage differences because there are no significant differences in costs between business and PBX trunks.

The Commission agrees. It finds that costs and usage of the services are similar, though not identical. Based on the evidence in this case, there is no justification for pricing PBX trunks differently from a business line. The rate for a PBX trunk shall be set at the same level as the statewide rate for a single business line, \$25.00 per month. NAR and DSS rates shall be established by aligning the rates with the single business rate, reduced by the Network Access Channel (NAC) or NAC equivalent.

TRACER and DIS have shown and the Commission finds that NARs and DSS services require separate purchase of the equivalents of the NAC and the switch interface non-traffic sensitive central office equipment (NTS-COE). If the NAR and DSS prices were set at the business line price, the Centrex and DSS customer would be charged twice for NACs and connections to the USWC switch (780-T, 9). Staff, TRACER and DIS recommend that the NAR and DSS be aligned with the new business rate but adjusted so as to avoid double charging customers for the NAC.

The Commission accepts the Staff, Tracer, and DIS position for the reasons stated and sets the rate for NAR and DSS trunks at \$14.00, by subtracting the NAC rate established in this order from the newly-established statewide business rate.

3. Direct Inward Dialing (DID)

USWC's proposal would increase DID trunk termination recurring rates from \$33 to \$40 per month and increase non-recurring charges by \$10, based on USWC's asserted need to increase revenues.

Commission Staff states that these proposed increases are not cost justified. DOD/FEA argues that the rates are anticompetitive because DID rates are paid only by PBX users -- DID is provided as part of the feature package of Centrex Plus service. The effect is to broaden by \$7 per trunk per month the price advantage of USWC's service relative to competing PBXs.

DIS and TRACER recommend that DID trunk terminations be reduced because of the service's importance for E-911 (allowing call back) and because the price is currently many times the service's TSLRIC. DIS and TRACER recommend the lowest practical price. In lieu of such a rate, DIS and TRACER endorse the \$16.50 rate for one-way DID that is in place in Oregon. Public Counsel/AARP contend that USWC failed to demonstrate that this rate increase would affect similar-sized PBX and Centrex customers in the same way.

The Commission rejects the proposed increase. The Commission finds that there is no cost differential sufficient to support rate increases. There is no revenue deficiency to be met. The Commission has above ordered that PBX line rates be brought into alignment with business rates and it reduced the average business rate. Holding the existing rate provides for sufficient contribution to shared and common costs and will avoid enhancing the Centrex price advantage.

4. Hunting

Hunting is a feature offered by USWC to customers using two or more lines. If the number dialed is busy or fails to answer, hunting automatically directs the call to the second line, or beyond if that line is busy. USWC proposes to increase the recurring rates for Hunting from \$2 to \$4 per month, based on its perceived need to increase USWC revenues. The Company proposes to eliminate the charge for the last line of a Series Completion Service hunt group since the last line does not hunt for another line.

Commission Staff opposes the proposed increase because it is not cost justified, and does not oppose eliminating the charge for hunting the last line. DOD/FEA points out that line hunting is included in the Centrex Plus feature package and that multiline hunting is a virtual prerequisite for the effective use of a PBX. They contend that the Company's sole motivation for this proposal is to improve the competitive position of USWC's Centrex Plus offering. DIS, TRACER and Public Counsel/AARP urge rejection for the same reasons.

The Commission finds that the USWC charge for this service is an example of monopoly pricing. Not only does it increase the competitive advantage of the Company's Centrex services, and not only is it priced at many hundreds of times its cost, but it appears to impose additional costs upon USWC and the general ratepayer body. First, because hunting is an important convenience -- nearly a necessity -- it adds to the effective cost and to the current inverted rate structure for additional lines. From that standpoint the charge for hunting masks the real charge of such lines and by increasing that charge operates to restrict sales of other lines that could also bring contribution to the system. Second, to the extent that the service is rejected because of its rate, it impedes business and personal efficiencies: outside callers are inconvenienced by having to call back or try another number. Third, if hunting is not purchased, the multiline customer may miss calls from persons who choose not to call back or dial another number.

For the above reasons, the Commission directs that the hunting charge be reduced

to 5¢, a figure appearing to be several times the cost of the service. This reduction, along with the reduction in average business rates, will operate to the benefit of small business customers. We expect that the reduction will stimulate sales of additional lines, adding contribution, although we do not reflect any additional lines in revenue calculations. We expect that inconvenience and missed calls will be reduced. All told, we believe that this will be a true win-win situation in which the customer benefits, the Company benefits, and the public benefits.

C. Zone Pricing of Local Exchange Service

The Company proposes to deaverage rates for local exchange services as a response to competition and to reflect its perception that costs of providing service in urban areas are lower. WITA endorses zone pricing. Part of the USWC territory, including all exchanges with EAS to metropolitan exchanges, would be declared urban. Remaining parts of its territory (including Olympia) would be deemed rural. Residential rates would be \$21.35 in the urban zone in the fourth year of the Company's phase-in proposal, and "rural" rates would be 20% or \$4.50 higher.

Commission Staff recommends rejecting zones because current average residential rates exceed the statewide average cost of residential service; business line rates far exceed the cost of service; and because it believes that competitive pressures have been overstated. In addition, the zones have anomalies in which some areas in the rural zone are more urban than some areas in the urban zone.

TRACER and Public Counsel/AARP argue that zone pricing has not been justified. Public Counsel/AARP opposes "loading additional charges on customers with even fewer options than those in urban areas." DOD/FEA support rate adjustments to reflect major differences in costs and believe the existing "value of service" rate group structure is out of step with the times.

It is clear from the record that the cost of providing service is not the same for every customer. The Hatfield model results adopted by the Commission show that the costs increase as the population density decreases. In other words, it does cost more to serve rural areas. Ex. 767. That factual conclusion does not, by itself, support a policy decision to adopt zone prices. The Commission finds that the existence of cost distinctions and the magnitude of distinctions depend on the particular service. Many factors led the Commission to reject zone pricing in favor of a single statewide rate. There is no demonstration that USWC's proposed zones correctly place exchanges in the proper zones. Indeed, USWC has included some very rural exchanges in its so-called "urban" zone. Even if USWC had proposed a cost-based division of exchanges, the two zones would have each contained exchanges that had different customer densities and therefore different costs.

The same logic that would support the zone concept would then call for dividing each zone into sub-zones, with the only logical stopping point being a unique rate for each customer, reflecting that customer's costs. That outcome is not one observed in competitive

markets or in the other industries subject to our regulation. Absent some compelling reason, such a radical change in pricing structure must be rejected. A statewide average rate promotes affordable local telephone service, minimizes rate shock, and provides USWC the ability to provide service at rates that exceed the average cost of providing service.⁵⁵ The Commission is willing to reconsider this ruling if competition takes hold and if doing so is permissible.

D. Business - Residential Relationships

USWC contends that its proposal for the first year retains a 2:1 ratio of business rates to residential rates but suggests that in the future rates should be consolidated.

Staff supports the near term business to residential ratio of 2.5:1 implicit in Staff's recommendations. Public Counsel/AARP support the existing ratio. DOD/FEA challenges Public Counsel/AARP's argument that the ratio between business and residential rates remain the same. DOD/FEA contends that business line and PBX trunk rates should be lower than residence line rates. TRACER says the Commission should give no weight to ratios and base their decisions instead on underlying costs and public policy considerations.

The Commission has no target ratio in mind when it establishes rates. It finds that each service is covering costs, although the business rates are higher above incremental costs. A simple ratio does not reflect other relevant factors in pricing, such as tax advantages, directory advertising advantages, repair advantages, etc., that the Commission may consider in pricing. With those reservations in mind, we note that the ratio of existing service is approximately 3:1 and the ratio we propose is approximately 2.5:1. We note that the existing ratio does not reflect the charge for hunting, which many customers may feel to be essential, and which we order substantially reduced. Nor does the ratio reflect charges for message toll service, which is also reduced.

E. Revenue Impact

The restructuring of residential flat-rated service to eliminate rate groups and EAS adders, and to establish a single statewide rate at the current average, has no revenue effect. The revenue effect of approved changes to the measured rate structure is \$385,000. The revenue effect of establishing a business rate of \$25 with no simple/complex distinction and no rate groups is a revenue reduction of approximately \$31,800,000 including the effects of stimulation.

⁵⁵ While we base our rejection of zone pricing on the policy considerations outlined above, it is worth noting that the federal Telecom Act appears to prohibit rate differentials that impose substantially higher rates on rural than urban areas.

VI. Toll and Access**A. Toll Services**

USWC's message toll rate proposal would compress mileage bands and decrease rates by \$18.6 million in the first phase and decreases mileage band rates by another \$17.4 million in the second phase. There would be no differential between the initial and subsequent minutes. Optional calling plans would be restructured and rates reduced, 800 Service Line hourly rates would be decreased, and TollPac discounts would be reduced from 30 percent to 15 percent by the second phase. The total reduction of these proposals is \$22.8 million in Phase 1 and \$19.8 million in Phase 2. USWC contends this is a competitive response similar to one that would be made by any party faced with a "dwindling market share." USWC contends that its toll call volumes have been shrinking at 3-5% per year while competitors' volumes are growing at 5-16% (Ex.55), and it proposes the rate reductions to allow it to maintain market share.

MCI opposes the new toll plans unless USWC satisfies the Commission's imputation standard. Specifically, it urges that USWC toll rates should not be reduced prior to lowering access charges to its competitors. AT&T argues that with USWC access rates many times the Company's direct cost calculations, the Commission should reduce the rates for access before approving any rate reduction for intraLATA toll. DOD/FEA believe that there are compelling reasons for toll reductions and observes that even if the proposal is approved, USWC intrastate toll will still be higher than interstate toll.

1. Message Toll Service (MTS)

USWC proposes to decrease toll rates by \$18.6 million in the first phase, and decreases mileage band rates by another \$17.4 million in the second phase. It proposes to eliminate the differential between the initial and subsequent minutes.

Staff supports the proposal to restructure and reduce rates for basic message toll service. It observes that costs are becoming less distance-sensitive, and a number of other toll service providers have adopted equalized minute rate structures. With the exception of some computational flaws and reservations about the Company's assumed price elasticity value, the Staff's witness, Mr. Selwyn, found the Company's calculations and methodology acceptable.

Staff contends that USWC's elasticity value is a one-year estimate and does not reflect the full anticipated demand response associated with the toll rate reduction. Using Staff's long-term estimate provides an additional \$8.3 million in net annual revenues to the Company. (Ex. 380-T, p. 71; Ex. 382, p.9)

Public Counsel/AARP support only modest toll reductions, and then only if a revenue surplus between \$50 million and a \$100 million is found. They contend that the Company has failed to demonstrate a genuine competitive threat to toll. Public Counsel/AARP

opposes having the same charge for the initial minute as for subsequent minutes because it exacerbates the existing disparity where residential MTS carries a higher margin than business MTS.

AT&T argues that the USWC proposal fails to afford true rate relief to consumers and that it is anticompetitive because it compels residential ratepayers to finance a toll reduction that increases the price squeeze on USWC's competitors, while ensuring that the Company maintains its revenue stream. Toll rates should be reduced, argues AT&T, but only as a byproduct of reductions in switched access rates that allow competitive forces to work.

The Commission agrees that the Company's concerns regarding toll competitors have some merit. In this Order we authorize USWC greater flexibility to adjust its prices to meet competition in a nondiscriminatory manner through banded rates. As markets become competitive, it is essential that the Company have the flexibility to transition into the role of a market competitor. It has had little practice as a competitor and banded rates are one mechanism permitted under regulation that will allow flexibility to meet competition within an identified range. In calculating its rates to meet its revenue requirement, the Company shall use and be prepared to demonstrate long run stimulation effects of lower rates.

The Company's proposal to reduce toll rates is reasonable and should be approved. We find Staff's estimate of the revenue effect to be the most accurate and we adopt it. We approve eliminating the premium for the first minute of toll, as it will result in rates that reflect the rate structures of toll competitors and that are easier to quote and easier to understand. We reject AT&T's request that toll reductions be contingent upon one-plus dialing for competitors' intraLATA toll; A rulemaking on one-plus dialing will soon move forward and we see no reason to deprive the Company of needed competitive ability and operating flexibility in the interim. The proposed phase-in of toll decreases was related to phased increases in local exchange rates. Because we have rejected those increases, the toll decrease should be implemented in one step.

2. Optional Calling Plans (OCP)

USWC's proposal for optional calling plans is to remove nonrecurring charges (NRCs) for the Plans, merge business plans into one and lower its rate; lower the rate for the volume plan; and add a 5% discount to business hour discount plan. USWC's revenue impact prediction differs from its calculation of revenue decreases from lower rates. USWC contends that the NRCs should not be eliminated.

Commission Staff says the Company's proposals for optional calling plans suffer from the same failure to use long-term estimates of elasticity as the Company's MTS proposal. Public Counsel/AARP and Staff believe that the Company should recover non-recurring costs, even if minimal, from the users of the OCP offerings, and Public Counsel/AARP agree that the Company's stimulation projections are inaccurate. WITA supports the development of a variety of toll discount plans and believes they should be available in independent LEC territory on the same terms and conditions as in USWC territory.